RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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February 14, 1979 **LETTER 750**

Feb. 2, DJIA 834.63; PTI 911; A-D Ratio –19.84
Feb. 9, DJIA 822.42; PTI 900; A-D Ratio –20.49

THE PICTURE: When the history of the great American inflation of the 1970's is written, it will be a tale of lies, greed and cowardice. One of the biggest lies is that debt expansion is synonymous with economic progress. One of the greatest examples of greed is seen in the massive US lobby that favors OPEC and its oil price rises; this lobby consists of weapons suppliers, international banks and many manufacturers of heavy machinery and transportation equipment. One of the outstanding examples of cowardice is the refusal of the US authorities to curb the monetary base. Let history be the judge.

The symptoms of the new "American disease" are easy to identify. Productivity in the US has declined from above 3% during 1945-65 down to a recent low of around 1%. Thus, the US productivity rate is even below Britain's rate and far below the rate of Japan and Germany.

The US is now dependent on many unfriendly nations for a long list of raw materials, not the least of which is oil. This over-consumption and under-production contributes to a $30 billion balance-of-payments deficit.

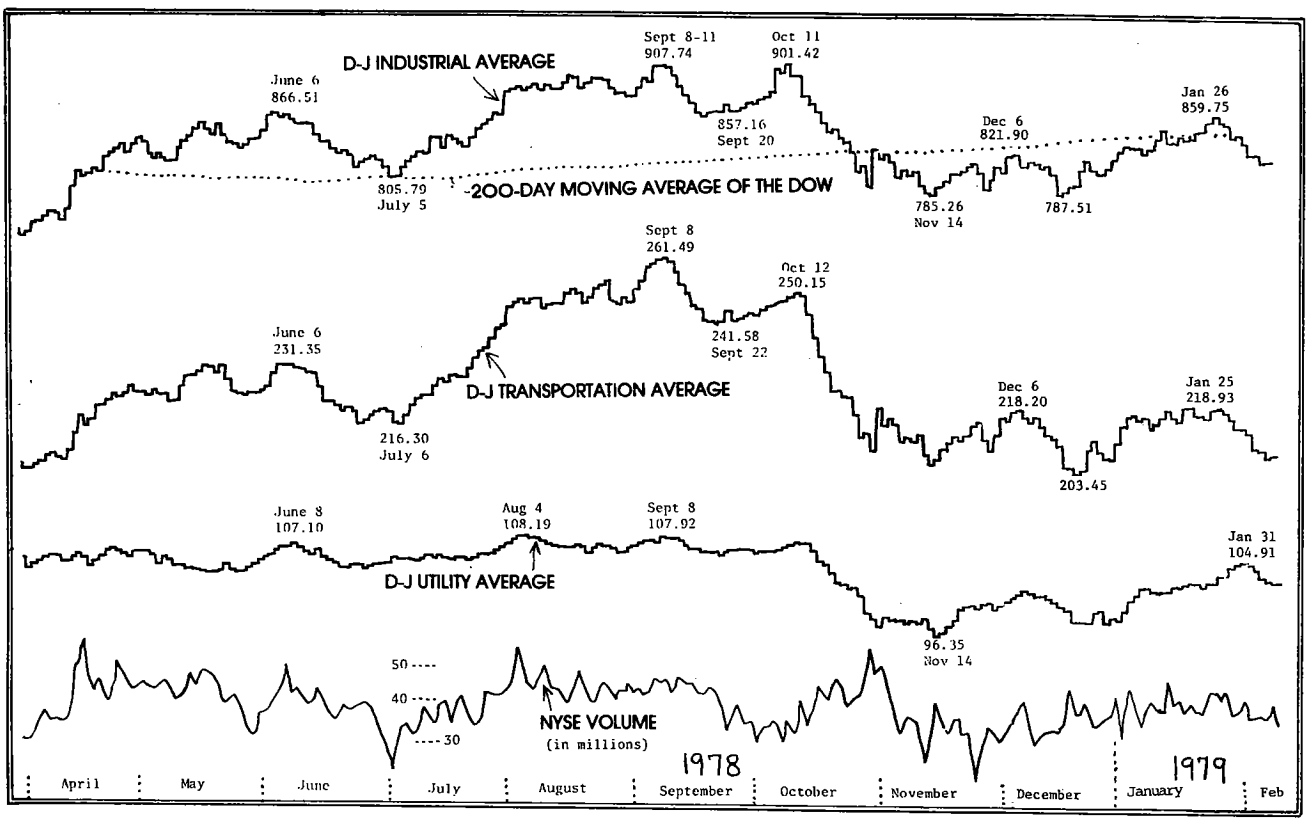
America, due to chronic and persistent inflation, has become a "spend now, invest (maybe) later" nation. Business investment (as a share of GNP) in the US is two-thirds the German rate, half the Japanese rate.

American consumers, demoralized by inflation, are saving at a record low of 4.8% of disposable income (in 1975 it was 8%). Thus, psychology is moving more and more to "spend it before they inflate it or tax it away," and investor interest in the stock market is slumping (count the stock market books in your local bookstore–some stores now carry none!).

In the face of all of this, many hard-nosed analysts continue to drone on about "stocks being basically cheap." But in the souring 1970's, "a cheap stock market" is simply one that has just collapsed and is ready for a recovery back into the 800's or 900's on the Dow. A major and sustained stock market rise into all-time high territory is a lost dream, a phenomenon that the great majority of brokers on today's Wall Street have never seen.

Most people don't realize it, but the Dow has marched substantially over 1000 **only once**, and that was 1973's push to 1051.70. Yet daily, even while great tide of events seem to turn increasingly against the US, some analyst will predict that "the Dow's going to 1200 to 1500 in the next year." Would that it were so! Would that this nation had the productivity, the competitiveness, the strength to be reflected by a 1200 to 1500 Dow!

"But won't inflation push the Dow way over 1000?" I am asked. "I don't think so," I answer, "I don't think so because we've been inflating the hell out of this nation all during the 1970's and the Dow is 200 points lower today than it was 6 years ago! At this point, inflation, rather than being an impetus, represents the simple destruction of the currency and the erosion of values. No, I don't think more inflation is going to do a thing for the market–except destroy it." That's a thesis that never seems to penetrate the murky minds of the Washington establishment.



The Feb. 9 issue of the WSJ (page 37) includes an article regarding Robert Salomon's (Salomon Bros.) thesis of debt "crowding out" the equity market. I consider this article to be one of the most important financial commentaries I have read in years. There, in print, is a confirmation of what I have been saying for the past year–the rise of debt in the US has gone "past the point of no return!" So great are the debt needs of this nation (debt required just to sustain the situation) that additions of new debt plus the costs of servicing the old debt are eating up the American alive.

Salomon offers the frightening comments that "the total net addition to debt (annually) will amount to almost 40% of the current $1 trillion market value of all outstanding common stocks." In other words, the annual debt requirements of this country are now devouring the potential market for equities. In the face of this, the stock market rallies continue to butt into a ceiling of 900 to 950 on the Dow. They might as well run into a brick wall.

The reason the market has held up even this well is (1) the "floating up" effects of inflation, and (2) the "great value" of stocks on an historical basis. BUT my feeling is that the pendulum is now turning, and the forces of debt (which are deflationary) are slowly tipping the balance down. Therefore, I expect the next major move (300 points or more) on the Dow to be down, not up. This move will, for the first time since World War II, be reflecting deflationary, rather than inflationary forces.

It is a mite too early to tell, but it appears that the second attack on the dollar of the last six months could now be on. With the renewed attack, the Administration will be forced to get off its hands. And if the dollar, for any reason, slides down towards its recent lows, the Administration will be under tremendous pressure to take **drastic action**. Such action could include another discount rate boost, increased gold sales, new dollar support measures, and possibly some form of credit controls. In the case of the latter, there could be restrictions on all kinds of credit: housing credit, auto credit, consumer credit. In that event I would expect chaos in the market.

I have been predicting VOLATILE and ERRATIC markets for 1979. The main reason for this prediction is that the economies of the world are now confronted with what I consider the *greatest battle of our generation*. This battle pits the forces of 35 years of unabated inflation against the rising (deflationary) forces of debt. As first one force, then the other, holds sway, the markets swing crazily up and down. These swings can be set off by a Government edict, a rumor, a political blurb, an attack on a currency, an oil price boost, a revolution in the Mid-East, you name it!

The net result of this new volatility, I am convinced, is going to be net losses to speculators and traders. Reason–there are going to be too many costly mistakes to offset the correct moves. My solution: assume a position of **liquidity**, which is basically 10% in gold, and 90% in Treasury bills. Such a position will be least likely to be smashed by the wild swings of the various markets. There are times when financial "discretion is the better part of valor." In the markets that I see coming up, there will be no heros, only survivors.

MARKET: Let's turn to the page 1 daily chart of the Averages. In the last Letter I noted that although the Industrials were putting on a fair performance, the Transports were reluctant followers. On January 25 the Transports closed at 218.93, which was a mere .73 above their December 6 high of 218.20. The next day (Jan. 26) Industrials pushed to a recovery high of 859.75. Alas, on the same day Transports declined, hovering just above their December 6 peak.

This weakness in the Transports was all the bearish hint any Dow Theorist needed. The market turned down with the Dow breaking the 840, then the 830 level. On February 5 Transports broke 210.

The daily tabulations of new highs on the NYSE was never impressive on the rally (the peak of new highs was only 51, recorded on January 26). On February 3 the high-low figures crossed over with new lows outnumbering new highs (the first time this had occurred since January 3).

From a Dow Theory standpoint, the market is again "caught" in what I term secondary territory, that area above recent important lows but below recent highs. A glance at the page 1 chart shows us that the important lows are 785.26 for Industrials, 203.45 for Transports. The important highs are 859.75 for Industrials, 218.93 for Transports. The ability of BOTH Averages to penetrate these two sets of points will signal the next IMPORTANT direction of the market.

The Utility Average is putting on a relatively good performance and is holding well above its November 14 low of 96.35. This is a plus which should not be discounted. Another plus is that the market is now acting somewhat "over-sold" on a short-term basis. It seems to be absorbing a great amount of bearish news in stride.

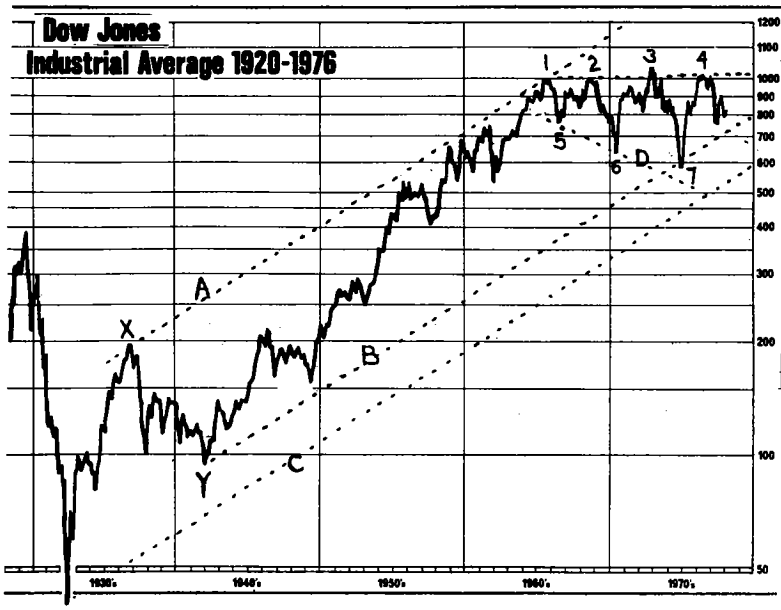
All of which makes me think that the market in this area is being subject to a cyclical "up-draft," or cyclical pressures which are attempting to produce higher prices. So the depressing news events of the day are serving to smother what might ordinarily be a move by the Dow back to say the 880 to 900 level.

What do I see ahead for the market? Here is my guess–based on the resiliency of the Averages, I would guess that we could have even higher markets into March or possibly April. But then I believe the major bearish forces which I have discussed in previous Letters (see Letter 748, page 3, on the Fibonacci projections) will take hold. I continue to believe that the major event of 1979 is going to be a drastic smash to a July low. I therefore think that all holding action and rallies in this area will be basically distributive in nature. In other words, I believe that large interests and serious investors will be selling into any strength that occurs from here.

Conclusion: use any strength in this market between now and Spring to sell into (if you still own stocks). Again, I say that liquidity is the critical element for the period between now and July, 1979!

PERSPECTIVE: To my mind, this very long term chart of the Dow is one of the most interesting charts in my collection. There are many who consider the path of the stock market as no more than a random walk, a mindless and haphazard meandering of stocks as they are blown this way and that by a mixture of truth and falsehoods, rumors and facts, economics and investor sentiment. I don't happen to agree. Not only do I believe that stocks respond rationally to situations and events, I think the pattern of the leading stock averages provides a map which, if read correctly, can provide us with critical information regarding future POSSIBILITIES.

With that long-winded statement in mind, let's examine the accompanying ratio chart of the Dow, a chart that takes the



Dow through a span from 1920 to the present. To my mind, it is clear that the crash of 1929-32 ended an era in the stock market. At the 41.22 low of July, 1932, a new era began. By 1937 the Dow had risen over 500% to 194. I have marked an X at the important 1937 top. From 1937 the Dow declined to the famous 92.92 low of 1942. I have marked a Y at the 1942 low.

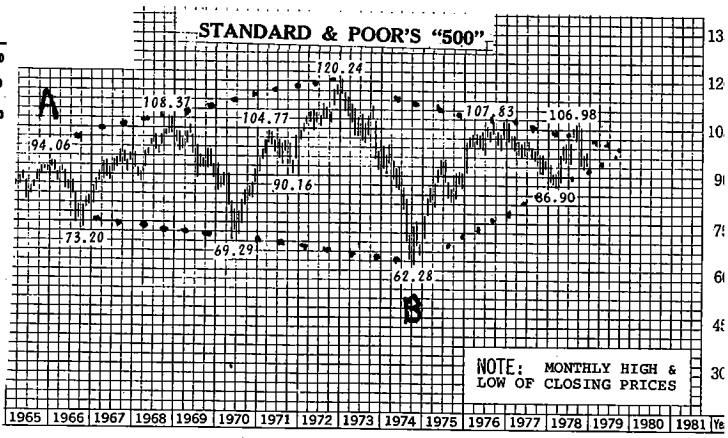
From 1942 the Dow rose to a peak of 212 in 1946, declined to 161 in 1949, then rose in an extraordinary bull market to a high of 995 in 1966. Whether one considers the "bottom" of the bull market to have begun in 1942 or 1949 makes no difference on this chart. I have connected the peaks of 1937 and 1966 with a trendline marked A on the chart. Then I drew a parallel trendline starting from the 1942 bottom at Y (trendline B). Next I drew a third parallel trendline starting from the 1932 low, and I marked this trendline C.

Note that all the Dow movement since 1932 has been held within trendlines A and C. And all the Dow action since 1937 has held within the narrower space of trendlines A and B.

Since 1966 there have been four successive stabs at the 960 to 1050 upper zone of the Dow. Each of these four stabs has failed, and each was followed by a worse collapse. I have marked the four upward stabs 1, 2, 3 and 4. I have marked the successive collapses 5, 6 and 7. Number 7 was the 1974 smash to 577.60 on the Dow.

I want to make two points regarding the current position of the Dow. First, it would be well to note Edson Gould's "Rule of Three's" and the market. The rule states that the price movement can try three times to go through a given level. On the fourth try the price movement will either make it in a major way or fail in a major way. Based on the rule of three's, I would say that at point 4 on the chart (1014.79 in September, 1976) the Dow failed for the fourth time to better the 950-1050 zone. This was a major failure and perhaps the most significant failure since 1966.

Secondly, the Dow, as time moves on, must either push above 1000 or fall below rising trendline B. Trendline B now intersects the Dow in the 750 area. If, on any decline, 750 does not hold, I would expect the Dow to contact trendline C coming up from the 1932 low. Trendline C now intersects the Dow at around 570



or in the vicinity of the 1974 low. If trendline C could not hold, I would guess that the US and the Western world would be facing some kind of disaster.

As an interesting aside, I include this monthly chart of the broad S&P 500 Stock Average (courtesy Horsey, Salisbury, MD 21801). Most investors aren't aware of it, but since 1966 (A on chart) the S&P 500 has been swinging in ever-widening arcs with each high above the preceding high and each low under the preceding low.

This "broadening pattern" evidently ended at the 1974 low (B). Since then, we have seen the opposite effect with the price movement moving in a narrowing pattern towards the apex of the triangle which I have drawn on the chart. A decisive breakout of this triangle would seem to offer a good forecast of things to come with an even more certain forecast provided if the 500 goes above the 1976 high of 107.83 or below the 1978 low of 86.90.

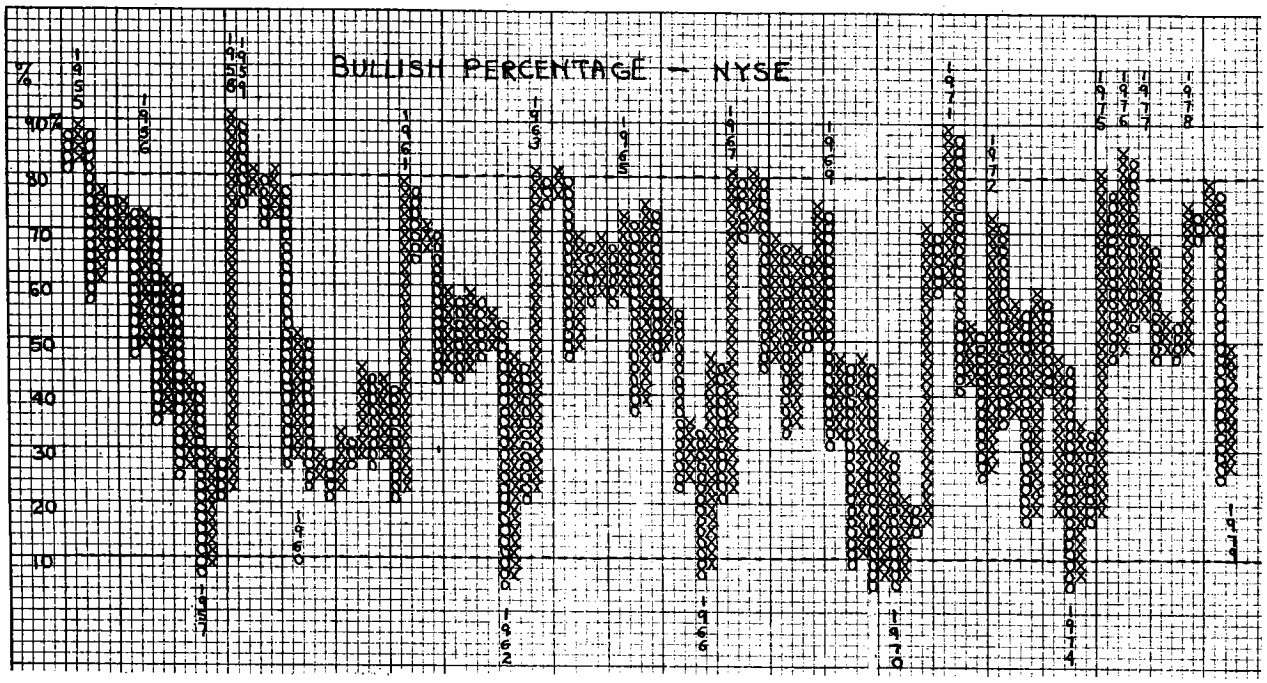
So both charts show the major price movement locked into a triangle pattern with the moment of truth drawing steadily closer. As the price movement approaches the point of the triangle, it is not unusual to see the price action grow dull and listless. This is what we may be seeing now as the market, like a giant coiled spring, readies itself for the next major impulse.

HOW LOW? There are any number of oscillators, counts, moving averages and other techniques through which analysts and investors attempt to identify major tops and bottoms in the stock market. I use approximately six methods myself, but it is seldom that all six methods dove-tail so that I can shout, "I see it, this is it, the perfect bottom!"

One of the simplest and most effective methods of identifying probable major bottoms is through a count of the number of stocks in the NYSE which are in bullish patterns. This method has been made relatively easy through the work of Chartcraft of Larchmont, NY. Each week they rate each and every one of their NYSE point & figure charts as either bullish or bearish. Then they tabulate the percentage in bullish trends. I keep track of this bullish percentage on a P&F chart, and the results are seen here.

The chart goes back almost a quarter of a century to 1955. During that period the bullish percentage study has been very helpful in identifying major tops and bottoms. But since bottoms are usually of shorter duration than tops (since bottoms tend to be violent and of a climactic nature) I would say that this study is more effective in calling bottoms than tops.

As a general rule, anytime the bullish percentage (BP) goes above 80%, stocks are in a very high risk area, and the market is probably in the process of forming a top. These top areas are



clearly seen on the chart. And anytime the BP drops to 10% or lower, we can be reasonably certain that the worst is being fully discounted and that a major bottom is near or at hand. Major bottoms are clearly identifiable during 1957, 1962, 1966 1970 and 1974.

Good enough, you say, but how about the current period? During November, 1978, the BP dropped to 26%, well below the neutral 50% level, but NOT LOW ENOUGH to signal a major bottom. Since then the BP has climbed to 51%, a rise of 25 percentage points but perhaps significantly this latest rise stopped around 50%.

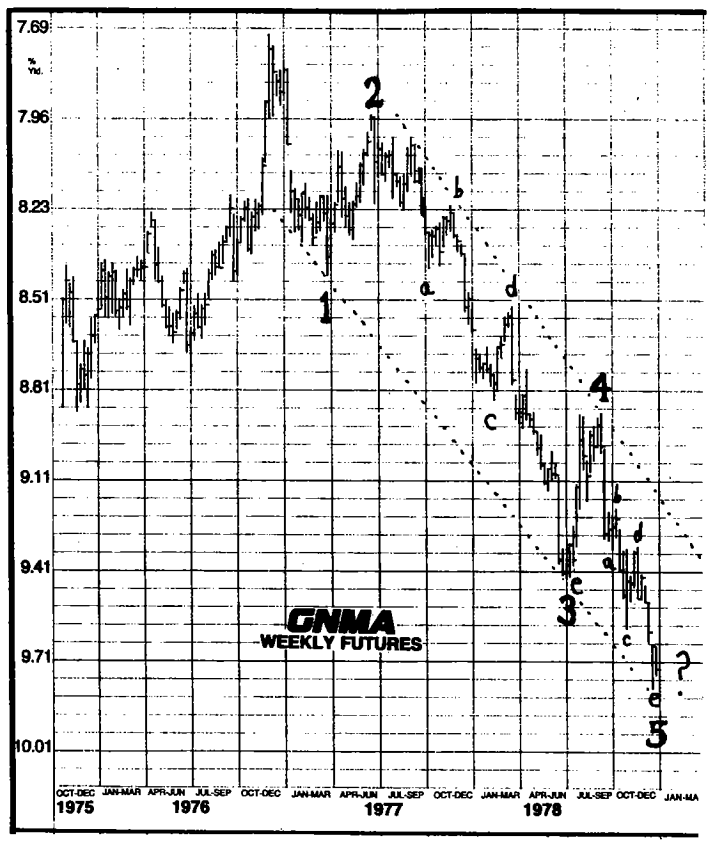
Based on past case histories, buying here (in the absence of a major oversold bottom) with the BP at 49% offers a poor risk/reward. This is true even if the BP now pushes up again to 80%, as it did following the 1960 low of 22% on the BP. The odds now heavily favor a decline to 10% or below in the BP rather than an extended advance back to the 80% overbought zone. Of course, the market can do anything, but in this business if you continue to ignore probabilities you are heading for losses.

Note that the index recorded a high of 86% in 1976, dropped to 48% in 1977, then rallied to 80% in 1978. This is the first time that the index pushed into the 80% area twice with never a plunge into oversold (10% or below) territory. The odds would now seem to favor an ultimate move down in this index to a bottom area of 10% or less.

The point of this whole study is that I want subscribers to understand that the stock market is unattractive on the basis of this bullish percentage study of all common stocks on the NYSE.

BONDS, DEFICITS: Here is the chart that had me scratching my head (chart courtesy of Commodity Price Charts, 219 Parkade, Cedar Falls, Ia 50613). The chart pictures the weekly action of the General National Mortgage Association bonds, the so-called Ginnies. The Ginnies are debt put out by an agency of the US Government, and they are therefore highly rated.

The chart seems to show a perfect 1-2-3-4-5 decline in the Ginnies, and this jibes with the pattern of the US Government



bonds. This 5-leg collapse had a "completed look," and on the strength of that I thought it would be worthwhile "getting our feet wet" in the US bonds. At worst, I felt a good rally lay ahead. But with last week's action, I feel discouraged about even a decent rally in the bonds. The dollar (due to Administration cowardice) is still too weak, interest rates act as if they could go much higher, and the bonds go down "too easily." For this reason I would now say, "Sell your pilot positions in the bonds and get back into 91-day Treasury bills. It seems the money market storm has a good deal further to go."

Now turn to these statistics put out by the Associated Press. Note that total public debt to date is $790 billion. It won't be

Government Finances

WASHINGTON (AP) — Here are the figures on government spending and debt (last six digits are omitted) as of Feb. 1:

Total public debt	788,978
Interest on public debt for Dec.	8,138
Int.fiscal year through Dec.	6,105
Budget deficit for Dec.	3,915
Budget deficit for Dec. last year	4,852
Budget deficit fiscal year so far	23,767
Estimated deficit fiscal 1979	37,379
Outlays fiscal year so far	123,217
Outlays same period year before	113,306
Gold for Dec.	11,671

long before the US hits another milestone, a public debt of $800 billion! If you figure average interest rates of 9%, we are heading for whopping increases in the cost of carrying the public debt, interest costs that will ultimately force this country into a deflationary depression. I base this on the truism that ALL DEBT is eventually paid off or renigged upon. To pay off the US debt would entail the greatest belt tightening and hardships the country has ever seen. To renig on the debt would be to declare bankruptcy.

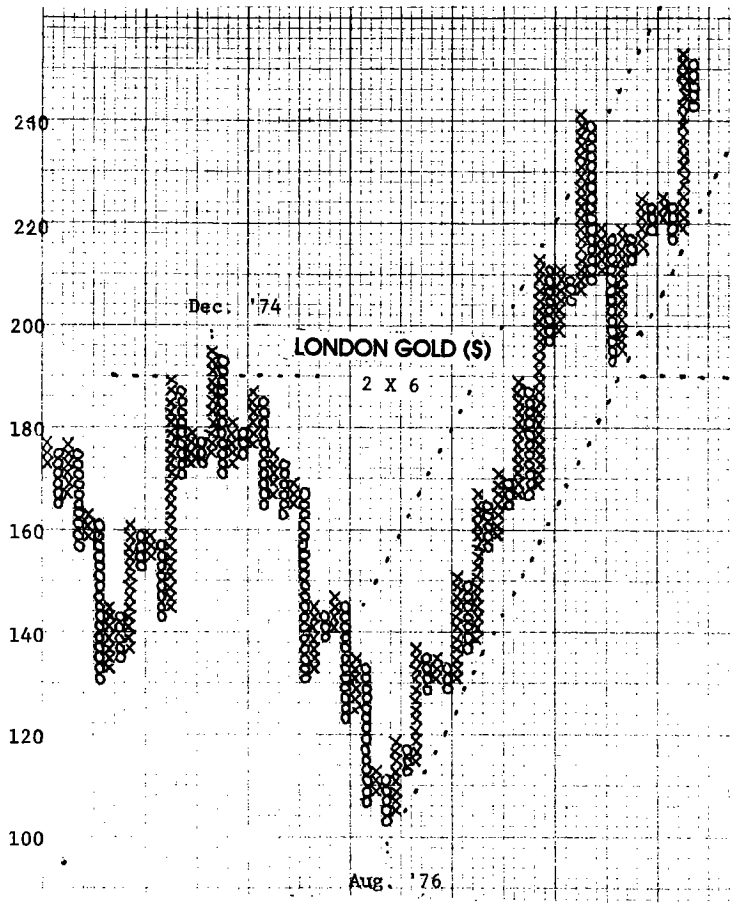
The day of reckoning can be forestalled by further inflation, but I am more and more of the opinion that the US public will not stand much more in the way of inflation. Already inflation is a spearpoint of political action, and California's politically sensitive Governor Brown has finally understood the significance of the debt picture and is now opting for a Constitutional Convention to make a balanced budget the law of the land. Many people smirk at the idea of Jerry Brown pushing budget-balancing but I tell them that they're underestimating both Brown and the temper of the people. I firmly believe that the American people are fed up with lies and deceptions about Government spending and Brown has recognized this and has practically staked his political future on it. For that honesty and courage, I take my hat off to him. The revolt against Government spending, I believe, is going to grow much bigger than almost any of the politicians realize.

At any rate, all this militates against the US Government forever inflating away the rising costs of the debt. So what's the answer? I don't have one. The only thing I offer is a plan for survival. And that plan of survival calls for a mixture of Treasury bills and gold. And the main question is the ratio of the mixture (and of course, I'm talking now on the basis of LONG TERM planning).

Here's a little nightmare that I have. Somewhere during 1979 (or perhaps in early 1980) the US economy slips into mild recession. The recession is greeted with near-joy by Wall Street and business ("Ah, at last, a chance to make money in bonds and a big new low coming in stocks"). The recession then deepens, and a few major bankruptcies occur. The rate of inflation is at last declining, and this is greeted with loud hurrahs by the Government. But it is slowly dawning on people that the recession is turning nasty. Unemployment is rising and more bankruptcies are announced.

Then, with a frightful suddenness, bankruptcies (due to extremely low corporate liquidity) become rampant. A panic for cash is on. Almost overnight CASH becomes the crucial element in staying alive, and in a flash EVERYTHING IS FOR SALE–houses, cars, land, collectibles, even gold. Gold drops violently, down to the 150 level as it is thrown over for cash. Then it happens: rumors abound that the $700 billion Eurodollar market is in trouble. Further rumors of a major bank collapse are heard. With the very existence of the dollar in doubt, with almost all former gold holders wiped out, gold turns up. Within a month gold hits 300. Two weeks later, with dollar credibility sinking, gold goes over $400.

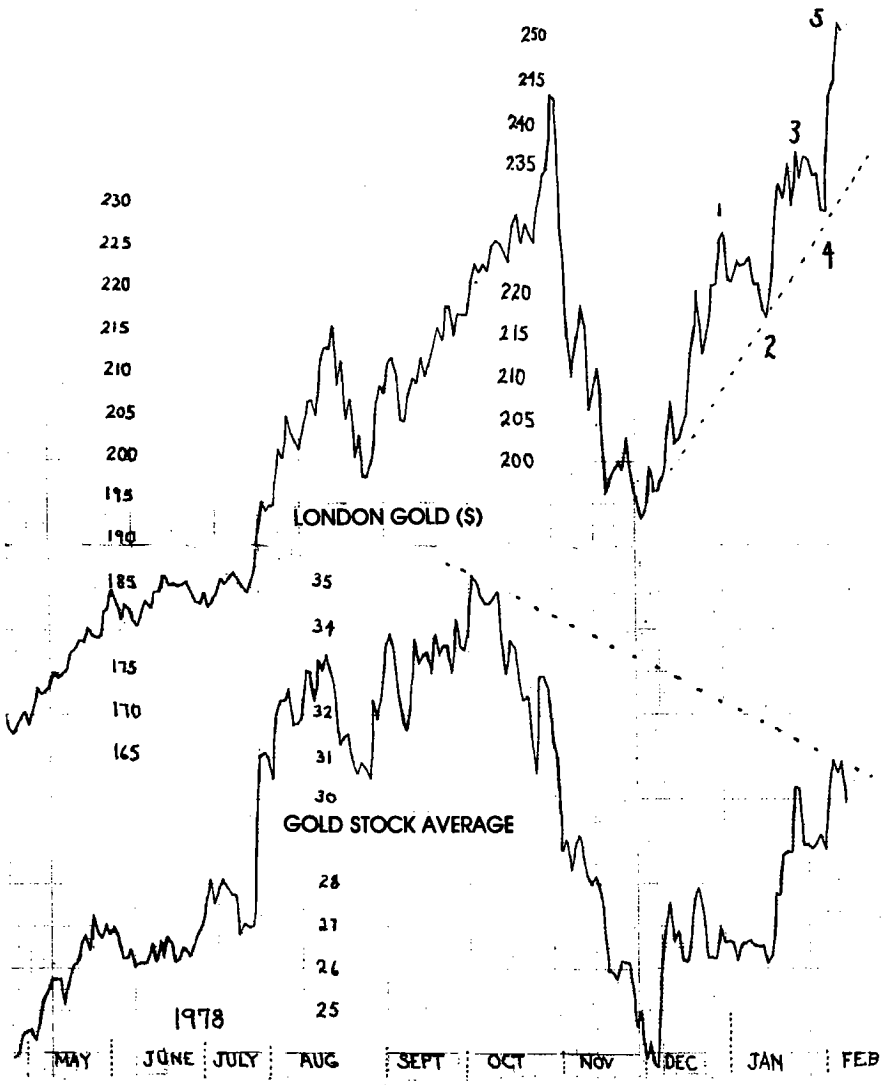
It is seen that the Government (which is now issuing "hopeful" edicts daily) is helpless to turn the primary bear tide. Gold pushes even higher and.....and there my dream turns into a nightmare, and I wake up.



GOLD: This chart is my 2 x 6 point and figure chart of gold (1st and 2nd daily London fixes). Every box on this chart equals 2 points, and only advances or declines of 6 points or more are shown (rows of X's denote advances,rows of O's denote declines).

I have adjusted the rising channel lines to take in the latest action in gold, and I believe these new channel lines are valid. At the October high of 243 gold temporarily pushed above the upper trendline, at which spot it was technically overbought. Next came the plunge to 193 which ended in early December. From the December low gold advanced to the 226 area, consolidated, then rallied again. The latest advance has taken gold to a second fix all-time high of 251.60 (Feb. 7). On February 8 gold backed off a bit, and on Feb. 9 gold became as erratic and "whippy" as I've ever seen it. By the close of Feb. 9 gold was down to 246.75, and I took this action to be a "test" of the previous 243 peak.

I have mixed feelings about gold here. The pattern on the gold chart since the October high is about as weird as anything I've seen on a point & figure chart. Note the sprawling, "wild" look of the recent action. Much of this, of course, can be ascribed to shocking world events such as the OPEC oil rise and the Iranian uprising. One thing the chart does show, however, is that gold is about in the center of the rising channel and that the lower



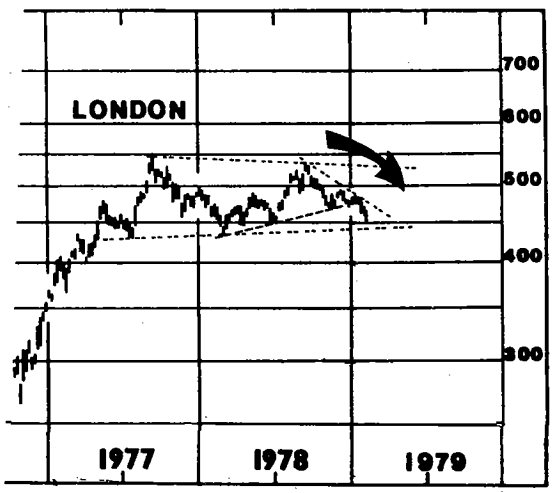
trendline comes in at about 220. I would say, based on this chart, that it would require a price of 216 to turn gold bearish. Otherwise, the trend should be considered up.

Now let's turn to the gold chart above (daily 2nd fix) and my gold stock average (GSA). From a technical standpoint, I like the two items to confirm each other, as they did on the rise to the October high. But that has not been the case on the most recent advance from the December lows. Two factors on this chart should militate towards caution, as far as gold is concerned. The first is that there is now a striking non-confirmation on the part of bullion and the GSA. In fact, as of Feb. 9 GSA had recovered only about 50% of its violent October to December losses. I have drawn a declining trendline through the October and February peaks on GSA.

The second item suggesting caution is that gold has now advanced in a definite 1-2-3-4-5 pattern, and it is leg number 5 which is usually the most violent and speculative. By the same token, leg 5 is the one which most often completes a movement. On this chart, the rising trendline for gold would meet any decline at a price of about 225. Thus, as long as the gold action holds above 225 the trend should be taken as bullish.

Subscribers should remember that gold at 240-250 is about only 10% above the area where it was four months ago in mid-October and only a few points above its ultimate October peak. I continue to feel that insurance positions in gold are warranted, and by that I mean about 10% of assets (or somewhat more, depending on your disposition). But enough things bother me about gold at this time to make me exercise caution. At 240-250, I feel it is too vulnerable to load up on. But as readers of these Letters know, I've been wrong before.

MUSINGS: London is always worth watching because their market often precedes ours in the matter of major moves. Britain just raised its bank rate 1.5% from 12.5% to 14%. When it comes to fighting inflation via interest rates, the British (unlike the Americans) don't fool around. This chart from my good friend Ian McAvity's *Deliberations*, PO Box 182, Adelaide St. Sta., Toronto, Canada M5C 2J1, shows what has been happening to the Financial Times Average. Having formed a double top in the 550 area, the Average last week dipped to the low 450's. A break below 440 would look ominously bearish for the British market–and economy.



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I gather (from what I hear so far) that Iran now belongs to the followers of Islam. This probably means that Iran will permanently cut back on the amount of oil it will export. Next on the "big change" parade should be Saudi Arabia. The cry is, "Conserve our oil, don't sell it to the foreign devils!" The Saudis, I would guess, are getting the message. All of which will mean ultimate changes in US living habits. Detroit's loss may be the moped industry's gain.

* *

The flak is flying regarding the prospective Constitutional Convention which will seek to force a balanced budget in the US. Business Week calls the move "nonsensical." I disagree. The LAW is the ONLY vehicle which will force Washington to stop spending more than they are taking in. The Constitution guarantees us freedom of speech, freedom of religion, freedom to bear arms. Why not freedom from robbery via planned Government inflation. When Carter boasts about a "Lean and austere" budget deficit of $30 billion, it's time for a Constitutional amendment.

* *

If the "off-budget deficits (covering six Federal agencies) were included in the current budget (and they should be included), Carter's projected deficit for 1979-80 would be $42 billion, not $31 billion. And the subterfuge goes on . . . . .

NEXT MAILING: February 28th